

PNG economic survey: a scorecard for the Morauta administration

Ron Duncan

The Morauta Government, coming to office with high hopes two years ago, has seen the economy do very poorly in 2001. This poor performance has occurred despite strong efforts by the government to improve the economic environment through reform of institutions and policies. While the economy did well in 2000, in 2001 real GDP is likely to show no growth and could even decline by 2–3 per cent, especially if global economic conditions deteriorate as widely expected. Papua New Guinea's creditworthiness has also been downgraded. The reasons for the seeming collapse in confidence in the economy are not easy to pinpoint.

Ron Duncan is Director of the Asia Pacific School of Economics and Management at The Australian National University.

The Morauta Government has been in office for a little more than two years. Great expectations for the government have been held by international financial agencies, concerned donor governments and Papua New Guineans themselves. It is almost certainly true that behind many of these expectations there was not sufficient recognition of the obstacles and risks that the new government faced. In setting out to evaluate the performance of the Morauta administration, therefore, this survey tries to give sufficient recognition to the difficulties faced by the government in its attempts to improve the country's performance.

Two years is obviously a very short period within which to bring about major changes in the management of the PNG economy. It is also a very short period over

which to evaluate a government's performance. Two years is also a short period in terms of the availability of data with which to make an assessment of the government's performance and its impacts. Production data such as GDP do not become firm for several years after the event, so it is not possible to judge the performance of the Morauta administration in terms of output and employment effects. Hence, this survey mainly relies on what might be called current prices, such as the exchange rate, the consumer price index (CPI), interest rates, and even share prices, as well as other indicators of economic agents' perceptions of the economy. These prices essentially convey the market's real-time evaluation of the administration's performance and its impact, even into the future.

Economic survey

When the Morauta administration took over in July 1999, the budget was in substantial deficit, public debt was over K5,700 million, interest rates on Treasury Bills were around 22 per cent for 28-day bills and 26.5 per cent for 182-day bills, the Bank of Papua New Guinea's international reserves were valued at K228.3 million—equivalent to only 1.9 months' import cover—and the kina had depreciated substantially against the currencies of Papua New Guinea's major trading partners. The nominal exchange rate for the kina fell from US¢70 in 1997 to US¢29 before the change of government (Papua New Guinea 2000).¹ The kina's decline was obviously related to fiscal and monetary measures that had resulted in inflation in 1999 running at a rate of more than 13 per cent.

In attempting to stabilise the economy, the Morauta administration's main short-run objectives have been to reduce the fiscal deficit and to reduce the level of public indebtedness and thereby reduce pressure on interest rates. To improve the government's long-run performance, its main focus has been on improving the government's management, regulatory and oversight capacity. In addition, it has been trying to reduce the tasks that the government has been attempting to undertake and to focus its attention on core activities. One way in which the government is attempting both to reduce public debt and reduce the tasks of government is to privatise many of the publicly owned and run enterprises. More generally, it has also pledged to provide a more market-friendly environment for investors. An important part of its efforts to bring about greater fiscal and monetary discipline was to give greater independence to the central bank, the Bank of Papua New Guinea, through the new Central Banking Act of June 2000.

The Supplementary Budget of August 1999 and the 2000 Budget resulted in the 2000 fiscal deficit being slightly reduced from 2.2 per cent of GDP at the end of 1999 to an estimated 1.8 per cent at the end of 2000. The

2001 fiscal deficit is projected to be 1.3 per cent (Papua New Guinea 2000). In November 1999 the government approved a Structural Reform Program (SRP) that was endorsed by the World Bank and the International Monetary Fund (IMF). The SRP incorporated reforms required by the international financial agencies as conditions for their support, such as improving central bank independence, strengthening supervision of financial institutions, reforming the public service and privatising public enterprises.

The SRP led to a total financial commitment to Papua New Guinea of US\$300 million by the World Bank, the IMF, Australia and Japan. Partly as a result, the Bank of Papua New Guinea's holdings of gold and foreign exchange increased to K625.5 million by June 2000—representing three months' import cover. The kina also increased in value against major currencies. This was due in part to a sharp reduction in broad money (M2) growth from 17 per cent in 1998 to 4 per cent in 1999. Inflation also fell, but only slightly, from 13.2 per cent in 1999 to an estimated 12.3 per cent in 2000.

The reduced fiscal deficit in 2000, together with the reduction in domestic public debt (to K1,775 million at the end of June 2000), took some pressure off interest rates. As a result, interest rates on Treasury Bills fell throughout 2000. Real GDP grew by 3.2 per cent in 1999 but is estimated to have grown by only 0.8 per cent in 2000 (Papua New Guinea 2000). The decline in the growth rate in 2000 was expected due to falling production in the oil sector, with the mining sector GDP declining by 7.9 per cent while the remainder of the economy grew by 3.3 per cent.

The 2001 Budget

The objectives of the 2001 Budget were to

- maintain a responsible fiscal stance and thereby reduce the fiscal deficit, slow the rate of increase in public indebtedness,

Economic survey

reduce interest rates and stabilise the exchange rate

- shift resources towards priority sectors that will foster development (health, education, transport, works, agriculture, and police and correctional services).

While it is said that the government's objective is to tightly control expenditure, salaries and wages were expected to increase by K687 million to 'repair some of the decline in the real wages of government employees' (Papua New Guinea 2000:15). It was said that this increase in wages and salaries would be offset in the future by the retrenchment of 1,380 public servants, saving over K20 million per year. But its initial impact would be negative.

No new domestic borrowing was expected. Instead, it was proposed to pay down K268.9 million of domestic debt using international concessional loans and proceeds from privatisation (K178 million). However, to assist with the retirement of public debt, external finance of US\$140 million from concessional lenders was planned for. The projected budget deficit for 2001 was K141 million, which was an estimated 1.3 per cent of GDP, compared to an estimated 1.8 per cent for 2000.

Total revenue and grants for 2001 were estimated to increase by 6 per cent to K3,223.3 million, with tax revenue growing by 7.1 per cent and reflecting 'improving economic activity, greater tax arrears collection efforts, greater tax compliance enforcement efforts and higher levels of personal income' (Papua New Guinea 2000). Personal income taxes were expected to increase by 15 per cent, due to wages growth and increased domestic activity. Corporate tax was also expected to increase, rising by 10.3 per cent due to the expected increase in economic activity. On the other hand, mineral and petroleum tax receipts were expected to fall by 20 per cent (from K393.9 million to K316.7 million) due to the continuing decline in petroleum production and the expected fall-off from the

high oil prices. Log export taxes were expected to increase only slightly due to a small expected increase in log prices.

Real GDP was expected to increase by 3.1 per cent in 2001, with non-mining GDP increasing by 5.7 per cent but with the mining and quarrying sector declining further by 6.5 per cent. This expected decline was mainly due to the expected 17 per cent decline in oil output.

2001 revenue forecasts

Making sensible forecasts of future government revenues is an important part of good government management, as is management of fluctuations in the various revenue streams. Over-estimation of future revenues can lead to chronic budget deficits just as can poor control of government expenditures or poor management of the government's contingent liabilities.

An assessment of the government's performance with respect to the forecasts of future revenues should recognise that, on the one hand, forecasts of volumes and prices are highly uncertain and therefore mistakes will be made. On the other hand, the forecasts should recognise the inherent uncertainty and be appropriately cautious.

From this perspective it appears that the government has not been sufficiently aware of the problems inherent in forecasting revenues or not sufficiently careful in making the forecasts. For example, with the exceptions of gold and oil prices, all commodity export prices were forecast to increase in 2001 (in kina terms for the non-mineral commodities and in US dollar terms for copper) (Table 1).

Up to July 2001, however, only international cocoa and log prices have increased in kina terms, while copper prices fell in US dollar terms (Table 2). All US dollar prices of the commodities in Table 2 have fallen in 2001—except cocoa—with copra, coffee, palm oil and logs registering large

Economic survey

Table 1 **Prices of main export commodities, 1999–2001** (kina per ton f.o.b., unless otherwise specified)

	1999 (actual)	2000 (est.)	2001 (proj.)
Copra	1,047	808	848
Cocoa	2,917	2,461	2,915
Coffee	5,220	4,351	4,981
Palm oil	1,331	1,002	1,237
Logs (kina/m ³)	195	217	246
Gold (US\$/oz)	279	274	268
Copper (US\$/lb)	0.71	0.85	0.91
Oil (US\$/barrel)	17.8	28.7	27.7

Sources: Papua New Guinea, 2000. *Economic and Development Policies*, Vol. 1, 2001 Budget, Government of Papua New Guinea, Port Moresby: Table 3.

falls. So large, in fact, that the large depreciation of the kina in terms of US dollars has not offset the fall. Thus, we see that the kina prices for copra, coffee and palm oil have been very poorly forecast, as was the US dollar price of copper. If the widely expected decline in the US economy takes place, US dollar commodity prices, especially for industrial commodities, could fall further. Moreover, the US dollar could depreciate against other currencies. Hence, kina prices of primary commodities could decline even further this year.

Total GDP was expected to increase in real terms in 2001 by 3.1 per cent. With the agricultural, forestry and fishing sector accounting for one-third of nominal GDP, the forecast 6.5 per cent increase in real GDP in this sector was the main contributor to the expected aggregate GDP growth. Hence the output and price assumptions for this sector are critical. With the exceptions of tea and logs, output in all agricultural export sectors was expected to increase (Table 3). This increase would likely have been based, in part, on the expected increases in export

Table 2 **World Bank commodity prices, 1999–2001** (kina per metric ton, unless otherwise specified)

(Jan–July)	1999	2000	2001
Copra	1,176.7	841.3	605.2
Cocoa	2,893.9	2,500.7	3,273.0
Coffee, arabica	5,841.4	5,299.5	4,655.0
Palm oil	1,111.7	856.5	838.3
Logs, Malaysia (kina/m ³)	477.1	524.4	536.4
Gold (US\$/oz)	278.8	279.0	270.0
Copper (US\$/mt)	1,573.0	1,813.0	1,681.0
Oil, Brent (US\$/barrel)	17.8	28.27	26.3

Sources: World Bank and IMF Commodity Price Data. Monthly prices in US\$ converted to kina at average US\$/kina monthly exchange rates.

Economic survey

prices. It may be that the forecasts of agricultural export activity were reasonable expectations, at the time, however, the optimism of forecasts for this sector contrasts with the realism of the forecasts of output and prices for the minerals and oil sectors. The forecast for log volumes of no change was probably determined as much by compliance with World Bank strictures on activity in this sector as much as anything else. The poorer-than-expected activity in the agricultural and mining sectors will likely be reflected in other sectors, adversely affecting the income and corporate tax collections—as is already evident from reported revenue collections for the first half of 2001.

It is likely too that the government's expected take from its 51 per cent share of Orogen Minerals Ltd was optimistic (Orogen paid US\$44.4 million in tax in 2000). Orogen Minerals Ltd reported a 27 per cent decline in first-half year earnings for 2001 as compared to 2000 (*Post Courier*, 21 August 2001). Total revenue in the first half of the year 2001 was US\$89 million, as compared to US\$119.2 million in the same period in

2000. It was claimed that the drop in earnings was linked to the delays in the finalisation of the PNG–Queensland gas pipeline proposal and in the Ramu nickel project. However, it is difficult to see how earnings from these projects could have been factored into year 2001 earnings. It is more likely that anticipated lower gold and oil earnings were not properly accounted for.

Clearly reflecting an appreciation of the poorer-than-expected performance across the economy, the Governor of the Bank of Papua New Guinea recently revised the 2001 GDP growth rate down from the 2001 Budget forecast of 3.1 per cent to 0.1 per cent (*Australian Financial Review*, 2 August 2001). The Prime Minister was reported to have told Parliament that the slow growth of the economy was due to the delayed release of a US\$20 million World Bank loan. But it is clear from the 2001 Budget papers that the GDP growth forecast was optimistic. The optimism might well have been justified if there had been greater surety about a reduction in Papua New Guinea's sovereign risks.

Table 3 Volume of main export commodities, 1999–2001 ('000 tons, unless otherwise specified)

	1999 (actual)	2000 (est.)	2001 (proj.)
Copra	63.5	68.0	71.4
Cocoa	29.0	45.0	48.6
Coffee	79.2	50.5	66.0
Palm oil	253.8	300.0	515.0
Rubber	3.7	3.2	4.0
Tea	8.2	7.0	7.0
Copra oil	50.3	41.9	43.9
Logs ('000 m ³)	1,312.3	1,500.0	1,500.0
Gold (tonnes)	63.0	62.0	57.7
Copper	143.9	146.6	158.3
Oil	30.6	23.4	19.4

Source: Papua New Guinea, 2000. *Economic and Development Policies*, Vol. 1, 2001 Budget, Government of Papua New Guinea, Port Moresby: Table 4.

Economic survey

Sovereign risk

There are several dimensions of sovereign risk that affect the performance of the PNG economy, and it appears that these have not been adequately factored into past budgets. They have likely also not been adequately allowed for by those who have taken an unduly optimistic view about the Morauta Government's ability to bring about significant improvement in the performance of the economy. That observers believe Papua New Guinea's sovereign risk has not improved as is reflected in the downgrading of its creditworthiness by Standard and Poor on 7 August 2001. Standard and Poor lowered Papua New Guinea's foreign currency sovereign credit rating from B+ to B, and the long-term local currency sovereign credit and senior unsecured debt ratings were lowered from BB to BB-, which it was said reflected 'failure to attract new investment to [Papua New Guinea's] minerals sector at a time when output is in secular decline...and weakening growth prospects are heightening popular resistance to economic reform' (*Post Courier*, 7 August 2001). Standard and Poor also said that it expected Papua New Guinea's standby agreement with the IMF to lapse in September.

Other signs of worsening sovereign risk are the sharp decline in mining exploration, and development and evidence of 'high grading' by mining companies. BHP Billiton's withdrawal from the Ok Tedi mining venture can also be viewed as based in part on an assessment that the investment climate is not going to improve, although environmental issues were probably more decisive. The decline in world metals prices could explain some of the decline in exploration and development. But exploration and development in mining, oil and gas are at an all-time low in Papua New Guinea, when oil prices are substantially higher than in recent years.

OTML (Ok Tedi Mining Ltd) reported higher grades in the last quarter of 2000 and

higher throughput (*PNG Resources* 2001). Porgera Gold Mine also turned in a better-than-expected performance in 2000 (gold production up 15 per cent) due to 'selective mining' and higher throughput—from 139,384 ounces in 1999 to 182,087 ounces in 2000 (*PNG Resources* 2001). These performances could indicate 'high grading' with a view to early exit because of increased uncertainty. Chand (2001) shows theoretically how increases in interest rates, indicating higher sovereign risk, can lead to highgrading of existing resource developments and reduced investment in new developments.

Political instability has been long recognised as a primary factor in the high level of sovereign risk in Papua New Guinea. The political instability translates into policy instability, as well as poor governance—including the politicisation of the public service and corruption at high levels in the government and in government bodies. The Morauta Government has made the reduction of political instability a major policy objective. Hopefully, a major step has been taken in the direction of reducing political instability and its flow-on effects by the passage of the Integrity of Political Parties and Candidates Act in November 2000. If it has had any positive effects in the short term, however, they have not been reflected in investor sentiment, or they have been overshadowed by other circumstances.

As Standard and Poor's comments remind us, the resistance to the economic reforms is growing, particularly resistance to privatisation of public enterprises. The apparently poor performance of the economy so far this year could worsen if the global downturn that is threatening takes hold. In that case, commodity export prices will deteriorate further and life could become even harsher. Economic reform is difficult at the best of times but a worsening economy would make it even more difficult. In that case, support of the international financial agencies could well be withdrawn.

Economic survey

The restoration of independence to the Bank of Papua New Guinea has been another major thrust in the government's measures to reduce sovereign risk. The passage of amendments to the Central Banking Act during 2000 have largely achieved this goal. Central bank independence had been seriously compromised with the sacking of several Bank Governors in recent years.

The World Bank's *World Development Report 2000/1* acknowledged for the first time—on the World Bank's part at least—that a country's macroeconomic management may be made more difficult and its economic growth reduced by the high level of instability and uncertainty of primary commodity prices. When a government's budget is highly dependent on a share of the revenues from primary commodity exports—as is the case in Papua New Guinea—in the absence of special measures, year-to-year government revenue may be highly unstable, which makes budgeting for recurrent and investment expenditure very difficult.

It is disappointing, therefore, that the government has closed the Mineral Revenue Stabilisation Fund (MRSF) and not replaced its revenue stabilising, exchange rate sterilising and savings functions with other instruments. The mismanagement of the MRSF has been well documented (AusAID 1995), including the changing of the drawdown rules that effectively destroyed the power of the Fund to stabilise revenues going to the budget, in addition to government borrowing against the funds held in the Bank of Papua New Guinea after 1992. The ineffectiveness of the Fund could have been avoided if independent trusteeship had been possible and balances had been retained in US dollar-denominated accounts.

Therefore, the instability of commodity export revenues remains a problem. There are various mechanisms that can be used to smooth the flows to the budget. The MRSF-type measure is an ex-post mechanism, which stabilises the flow into the budget after

receipt of unstable export revenues. Commodity market derivatives such as futures, options and swaps can be used to both smooth the export price fluctuations and to reduce the uncertainty of the flows. Another means of reducing uncertainty and stabilising revenues is to have the mining or oil producer guarantee the government a stable revenue stream rather than the government sharing in the price and production risks of export taxes or royalties. A mining company is generally in a better position to hedge these risks than is the PNG government.

2001 expenditure performance

There are two main areas for improvement in a government's performance with respect to the expenditure of revenues: loans and grants. The first is the efficiency with which the expenditure is carried out. The second is the effectiveness of the expenditure in terms of the prioritisation of the expenditure. The efficiency of the government/bureaucracy can be measured in terms of whether expenditure is kept within budget and the value-for-money of the expenditure. Value-for-money may be measured in terms of input indicators (which can be benchmarked over time within a department, or across departments) or in terms of performance or outcomes. Such benchmarking has not been a priority of past governments and it is too early to see the impact of the Morauta Government in terms of such measures.

However, while the impact of the Morauta Government in terms of improving the efficiency of government is difficult to judge over so short a time span, one worrying sign is that while total revenue and grants for the 2000 Budget were higher than expected by K179.3 million, total expenditure was also higher than expected by K138.3 million. This tendency towards lack of control over expenditure is one of long standing (see Gupta 1995) and was not corrected in 2000.

Economic survey

The effectiveness of government may be judged in terms of changes in the rate of economic growth and how well it achieves the equity or redistribution goals that it may have set. One indication of a government's likely impact on effectiveness is change in the priorities for allocation of expenditure. Economic growth depends in part on public investment in the highest return areas. Given a focus on 'quality' growth, that is, growth that will be strongly poverty-reducing, the emphasis should be on public investment that assists the poor—which is the bulk of the PNG population—to participate as fully as possible in the growth process.

The Morauta Government's expressed priorities for development expenditure have been on 'elementary and primary education, primary health care, transport infrastructure maintenance, law and order, and promotion of income earning opportunities for local entrepreneurs including agricultural producers' (Papua New Guinea 2000: Foreword). Given that by far most of the poor in Papua New Guinea are in rural areas and have great difficulty in accessing education and health services and markets because of poor or non-existent transport infrastructure, the emphasis on improving transport infrastructure and education and health services appears highly appropriate. The law-and-order problems and the poor income-earning performance in rural areas are important too but are largely a function of the poor infrastructure, education and health services. While roads, particularly feeder roads, are in a very poor state, requiring large maintenance programs, it is disappointing that provision for the development of new roads to reach more of the isolated poor has not been seen as a desirable goal.

The Morauta Government has lived up to its promises of strengthening the Public Investment Programme (PIP) in the form of increasing the share of government expenditure allocated to development. In 1998, the PIP share of expenditure was 6.6

per cent. In 1999, the share was increased to 8.6 per cent. In the 2001 Budget, the PIP share was estimated at 9.7 per cent, while the planned share for 2001 is 9.6 per cent. The real tests of effectiveness, however, will be whether the planned development spending materialises, given the tendency for PIP allocations to be the first to be held back when projected revenues fail to eventuate and/or recurrent spending balloons, and the manner in which these funds are spent. Unfortunately, development expenditure is the main area for 'grand corruption' in developing countries, mainly through over-tendering in construction projects. A study of a large number of developing countries (Pritchett 1996) finds that, on average, each public dollar invested created only 50 cents of capital. This suggests that public funds are not invested wisely, but there must also be a strong suspicion that there is substantial theft of public funds.

Privatisation

A major part of the government's reform program is the privatisation of public enterprises. Privatisation holds out the prospects for considerable benefits. The downside is that privatisation is one of the more difficult types of reform for governments to implement.

The sale of public enterprises in Papua New Guinea's case should have several important benefits, notably

- improving services and reducing their costs
- reducing the contingent liabilities of government
- reducing scope for corruption
- paying down public debt
- reducing interest rates
- reducing the scope of tasks undertaken by the public service to allow it to concentrate on core activities

Economic survey

- giving Papua New Guineans a direct stake in the companies and thereby improving transparency and accountability.

It is surely beyond argument that essential services (such as power, water and telecommunications) and other services such as air services, insurance and financial services are highly inefficient and very costly, leading to business costs being very high (Duncan and Lawson 1997). Papua New Guinea's publicly owned enterprises have had to receive government support (particularly Air Niugini). Their operation therefore represents a contingent liability for government that is not budgeted for and has been a source of budget over-runs (notably the PNG Banking Corporation).

On taking office, the Morauta Government put forward as a major reason for the sale of public enterprises the opportunity to reduce public debt and thereby reduce interest rates. This is a worthy aim. However, it appears that because of inefficient operation and maladministration, the enterprises are unlikely to yield anywhere near the amounts that were anticipated. But this also makes nonsense of the argument by the 'anti-privatisers' that the country's valuable 'public assets' should not be sold off. Still, the fact that the sale of the enterprises will not realise the benefits thought possible in terms of debt repayment and interest rate reduction is not a reason for not going ahead with privatisation. Other benefits in terms of reducing costs of services and improving services to the public and business, reducing scope for corruption, reducing contingent liabilities and concentrating public service resources on core government activities are more than sufficient reason to go ahead. Unfortunately, there has not been the progress anticipated with privatisation. To date no sales have gone ahead, so the debt pay-down anticipated in the budget has not been achieved. This puts a hole in the budget that will have to be met by further borrowing or reduced expenditure.

As stated above, reform of government business enterprises is one of the most difficult of reform activities. One of the main reasons for the difficulty is that the costs of adjustment—especially in terms of the loss of employment by both management and employees—are immediate and obvious, while the benefits that flow on to businesses, consumers and taxpayers are not obvious and may not be immediate. Another important and related reason that applies in Papua New Guinea as in many other countries is that public service unions are in a powerful position to resist the reform. Those resisting the reform are able to appeal to strong emotional notions such as 'selling the country's assets that have been paid for by our taxes'.

Where a particular reform is difficult to implement, one strategy that can be adopted to make the reform possible is to present it as part of a package of reforms that offers compensating benefits to those likely to suffer from the privatisation (see Haggard and Webb 1996). Haggard and Webb suggest that compensation in the form of education or health measures is better than subsidy mechanisms such as hiring incentives for employers, as once implemented, subsidies are usually difficult to remove. Unfortunately, given Papua New Guinea's parlous economic state, the possibility of offering compensating measures is financially difficult.

A second important lesson from the economic reforms carried out worldwide over the past 20 years or so is that reform is more easily implemented if there is 'ownership' of the reform (see OECD 1996; World Bank 1996). This means that there should be education of the public about the benefits and costs of the reforms. In particular, public sector unions should be closely involved in the discussions about implementation of the reforms and the best way to handle the adjustment costs for the labour employed in the enterprises being

Economic survey

privatised. In addition, parties that are likely to benefit from the restructuring should be included in the discussions to highlight the benefits that will flow.

The opposition to the privatisation in Papua New Guinea has been considerable. In part this may have been because the program was too ambitious. But it also seems that the public was not convinced of the benefits of the reform. In the upcoming election, privatisation is likely to be a major issue. There is a significant danger that attitudes against privatisation will harden and it will be seen as too difficult to carry forward in the next government. Failure to carry through with the privatisation program risks the IMF and World Bank withdrawing their support of the PNG government.

Market perceptions of the economy

With the unavoidable delay involved in obtaining statistics, such as output and employment, on how well the economy has performed over a period, useful 'real time' indicators of how the economy is doing are prices or other indicators that reflect how economic agents feel. Share prices, exchange rates and interest rates are such market indicators, as are foreign reserves, credit ratings and inflation rates. For a mining-intensive economy such as Papua New Guinea, minerals, oil and gas exploration and development is a useful barometer of investors' perceptions about the economy and government policies.

These 'market' indicators offer a very mixed perception of the PNG economy in 2001. On the positive side, interest rates (as reflected in 182-day Treasury Bills) have fallen fairly steadily since late 1999—from 20.58 per cent in September 1999 to 12.34 per cent in June 2001. Relatedly, since January 2000 commercial bank deposit rates (180 days) have fallen from 16.77 per cent to 8.53

per cent in June 2001. Bank of Papua New Guinea holdings of foreign reserves and gold have also increased steadily since July 1999 to where in June 2001 they stood at K1,092 million (equivalent to 4.6 months of imports).

Papua New Guinea's inflation rate is measured by an urban-focused consumer price index (CPI) based on outdated weights from a mid 1970s survey. Following the restoration of macroeconomic stability in 1995–96, the rate fell to 3.9 per cent in 1997. It then accelerated to 13.6 per cent in 1998 and 14.9 per cent in 1999 as the kina depreciated. Consumption has a high import content, and inflation tends to track the kina-US dollar exchange rate. Introduction of the value-added tax in mid 1999 had a one-off impact on the CPI that was offset in part by tariff reductions.

The year-on-year (average of 2000 on average of 1999) 'headline' inflation for 2000, as measured by the CPI, was 15.6 per cent, compared to 14.9 per cent in 1999. The increase in the headline inflation in 2000 was recorded in all expenditure groups due to the depreciation of the kina, an increase in public service wages of 5 per cent, the impact of excise duty on cigarettes and tobacco, and increases in the prices of several price-controlled items.

The 'underlying' rate of inflation, which excludes the effects of government policy decisions on consumer goods such as the changes in excise rates, increased by 11.8 per cent in 2000, compared to 16 per cent in 1999. The lower inflation in 2000 was attributed to the decline in the price of cereal, household items, miscellaneous food, and soft and alcoholic drinks. Inflation has continued to fall in 2001 with year-on-year inflation to June 2001 registering 7.9 per cent (*Post Courier*, 5 September 2001).

Other indicators, however, give a strongly negative indication of investors' perceptions. The value of the kina has fallen substantially since 1999, although significantly more in terms of US dollars than in terms of Australian dollars or Japanese

Economic survey

yen—reflecting the appreciation of the US dollar against most currencies. The kina was at a low point of US\$33.75 in September 1999 (A\$51.69) following a long slide from US\$47.70 (A\$77.66) in December 1998. The kina recovered for a few months after September 1999 in the wake of the Supplementary Budget and the agreement on the structural adjustment program, but fell again to US\$32.10 (A\$50.42) in January 2000. From this low point, it rose to US\$41.10 (A\$71.67) in May 2000, but since that point steadily declined to break below the US\$30 level in recent months. This slide in the face of the build-up in foreign reserves is puzzling but, in part, is likely to be due to continued capital flight in the form not so much of foreign investors withdrawing but of Papua New Guineans themselves investing elsewhere.

Another negative indicator is the decline in the price of PNG mining stocks. In August this year, the share price of the oil explorer and producer Oil Search Ltd (a partner with Exxon Mobil in the Hides Gas project) was trading at a six-year low. The shares of Orogen Minerals Ltd were also trading at their lowest price for some time, and, as for Oil Search Ltd, this was largely because of the failure to find new oil fields to compensate for declining production from Kutubu. The Highlands Pacific share price fall is due to the lack of a partner to develop its Ramu nickel project. That is due, in part, to the low nickel prices because of over-production. Lihir Gold's price has recovered somewhat but remains below its issue price in 1995 of A\$1.50. The collapse of exploration and development in mining reflects the loss of interest in mining in Papua New Guinea, not so much because of poor prospectivity, but because of perceived risks, particularly disputes over land. This may explain why exploration and development has declined, yet the country's risk premium as reflected in the rate of interest appears to have fallen.

But the most devastating indicator of all is Standard and Poor's downgrading

of Papua New Guinea's creditworthiness. The downgrade is devastating because it comes after the Morauta Government has made a huge effort to improve the investment environment. The downgrade noted the Bank of Papua New Guinea Governor's recent revision of the expected GDP for 2001 from the 2001 Budget forecast to 0.1 per cent and the opposition to privatisation that the poor growth was generating. It also noted the lack of investment in mining.

The fact that the country's oil production has fallen so fast in the past two years is most unusual in a country as prospective as Papua New Guinea.² Most oil-producing countries maintain proven oil reserves at around the same level over many years. Looked at from this point of view, oil reserves seem to be an economic indicator rather than a reflection of the quantity of oil in the ground. Thus it is hard to believe that the fall in oil production is due to anything other than perceptions of investment risk.

BHP Billiton's willingness to walk away from the Ok Tedi mine when it is supposedly entering its most profitable phase is another negative indicator of the mining environment in Papua New Guinea. The intention is to transfer BHP Billiton's 52 per cent share into a trust for the people of Western Province. Such a trust fund is in principle a good idea. It gives the people of the Province a stake in the company and thereby should reduce compensation claims against the mine. It should also provide a source of revenue for the Province. However, the key issue will be how well the trust fund is managed and the manner in which the earnings from the trust are used. The fund should be under independent management to ensure its integrity. The earnings from the fund may be distributed in a collective manner through investment in public infrastructure and expenditure on public services. Or they may be distributed to individuals, as is done in the case of Alaskan oil revenues held in trust.

Economic survey

This latter is not a suggestion to be shrugged off as there is considerable evidence that individuals spend much more wisely than governments do.

While the evidence suggests that investors have lost confidence in the economy, this is difficult to confirm. One measure that has been developed of the confidence that people have in a country's effectiveness in upholding their property and contractual rights is the contract-intensive money (CIM) index (Clague et al. 1999). The CIM index is defined as the ratio of non-currency money to total money supply (M2). The rationale for the index is that if people lose confidence in a country's institutions to provide assurance for the security of property (for example, in terms of adequate third party enforcement) the index will fall. That is, they would prefer to hold their financial assets other than in deposits in banks. The higher the CIM, the greater the ability of firms to raise

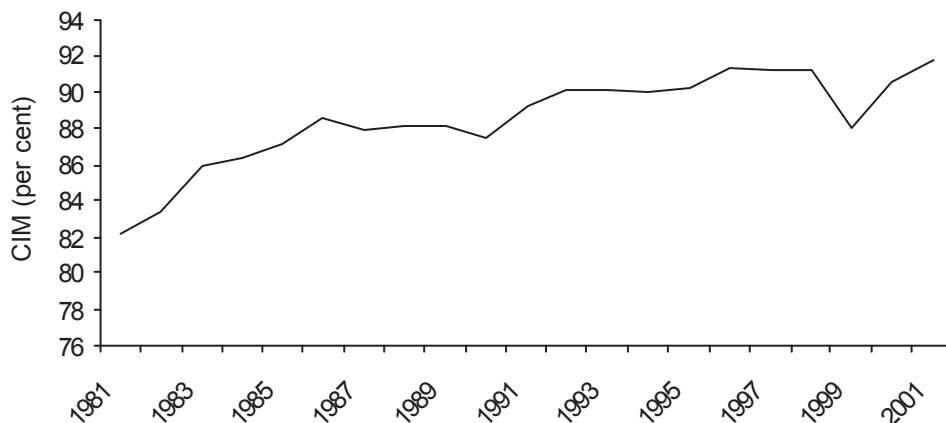
capital, the higher the rate of investment, and the higher the rate of growth.

The CIM for Papua New Guinea calculated for the period 1981–2001 (June quarter) is seen in Figure 1. It shows an upward trend in the ratio, with a dip coinciding with the fiscal crisis following the closure of the Panguna mine. The index recovers and increases during the Wingti and Chan administrations. Then there is a relatively large drop coinciding with the Skate Administration. In 2000 and up to June 2001, there is a recovery in the ratio to a level higher than previously. Hence, on the basis of this test, the Morauta Government is performing well.

Conclusions

The Morauta Government, coming to office with such high hopes riding on its shoulders, has seen the economy do very poorly in 2001.

Figure 1 The CIM ratio for Papua New Guinea, 1981–2001 (per cent)



Source: ADB Database (<http://www.adb.org>); Bank of PNG (various issues, 1998–2001). *Quarterly Economic Bulletin* Vol.XXIX No.1, Bank of PNG, Port Moresby.

Economic survey

This poor performance in 2001 has occurred despite strong efforts by the government to improve the economic environment through reform of institutions and policies. The economy did well in 2000 with real GDP increasing by 3.3 per cent, despite a 7.9 per cent fall in real GDP from the mining sector. Inflation and interest rates were reduced in 2000 and the exchange rate stabilised as foreign reserves increased.

However, in 2001 total real GDP is at best likely to show no growth and could even decline by 2–3 per cent, especially if global economic conditions deteriorate as widely expected. With population increasing by 2.5–2.7 per cent, this means a 2.5–6 per cent decline in real GDP per capita. Foreign reserves have continued to increase and interest rates have continued to fall. However, the exchange rate has depreciated throughout the year, plans for privatisation have not been implemented, investment plans for major resource developments have not been advanced, mining exploration and development has fallen to very low levels, investors are pessimistic about the mining sector as reflected in the low level of share prices, and Papua New Guinea's creditworthiness has been downgraded.

The reasons for the seeming collapse in confidence in the PNG economy are not easy to pinpoint. It may be speculated that because cynicism about corruption in the government and in government agencies appears to be running at an all-time high level, trust in the government is at a low level. This lack of trust is making it very difficult to move ahead with privatisation of government businesses. Privatisation is difficult to implement at the best of times. Under present circumstances the privatisation program may be far too ambitious, especially as it is likely to become a key election issue.

If privatisation does not go ahead, financial support of the international agencies is likely to dry up. The absence of funds from privatisation and the loss of

international support will cause problems in financing what already appears to be a rapidly deteriorating budget deficit. This would come on top of a developing budget problem that has arisen because of optimistic forecasts of primary commodity exports and export prices, and optimistic forecasts of GDP growth and therefore of taxation revenue. The deficit could be even further aggravated if the government has not been able to bring under control the tendency for departments to spend in excess of their allocation. Thus expectations about the fiscal situation may be a factor underlying the depreciating exchange rate.

Notes

- ¹ The decline in the value of the kina *vis-à-vis* the US dollar accounted for almost all of the increase in the external public debt from K1.9 billion in June 1997 to K3.1 billion in June 1999.
- ² For the eight-month period to August 2001, oil production was reported to be down 15 per cent on the previous year (*Post Courier*, 5 September 2001).

References

- Australian Agency for International Development (AusAID), 1995. *Papua New Guinea: improving the investment climate*, International Development Issues No. 39, ANUTECH, Canberra.
- Bank of Papua New Guinea (various issues, 1998–2001). *Quarterly Economic Bulletin*, Vol. XXIX No. 1, Bank of Papua New Guinea, Port Moresby.
- Chand, S., 2001. Managing natural resources in the Pacific islands, paper presented to a seminar on Natural Resource Management, Asia Pacific School of Economics and Management, The Australian National University, July.

Economic survey

- Clague, C., Keefer, P., Knack, S. and Olson, M., 1999. 'Contract-intensive money: contract enforcement, property rights and economic performance', *Journal of Economic Growth*, 4:185–211.
- Duncan, R. and Lawson, T., 1997. *Cost Structures in Papua New Guinea*, Discussion Paper No. 69, Institute of National Affairs, Port Moresby.
- Gupta, D., 1995. 'Current economic trends', *Pacific Economic Bulletin*, 10(1):3–13.
- Haggard, S. and Webb, S.B., 1996. *Voting for Reform: democracy, political liberalisation, and structural adjustment—an overview*, Sector Study No. 12, International Center for Economic Growth and World Bank, ICS Press, San Francisco.
- OECD, 1996. *Development Cooperation Report*, Development Assistance Committee, OECD, Paris.
- Papua New Guinea, 2000. *Economic and Development Policies*, Vol. 1, 2001 Budget, Government of Papua New Guinea, Port Moresby.
- Pritchett, L., 1996. *Mind your P's and Q's: the cost of public investment is not the value of public capital*, Policy Research Working Paper 1660, World Bank, Washington, DC.
- World Bank, 1996. *Aid Effectiveness: lessons for donors*, World Bank, Washington, DC.
- , 2000. *World Development Report: attacking poverty 2000/2001*, World Bank, Washington, DC.

Acknowledgments

Research assistance from Teuea Toatu is greatly appreciated. I also acknowledge helpful suggestions from Satish Chand and Tim Curtin.